

DEPARTMENT OF STATE REVENUE
LETTER OF FINDINGS NUMBER: 98-0536 ST
SALES & USE TAX
FOR TAX PERIOD: 1994 THROUGH 1996

NOTICE: Under IC 4-22-7-7, this document is required to be published in the Indiana Register and is effective on its date of publication. It shall remain in effect until the date it is superseded or deleted by the publication of a new document in the Indiana Register. The publication of this document will provide the general public with information about the Department's official position concerning a specific issue.

ISSUES

I. Sales & Use Tax – Tangible Personal Property Consumed in Direct Production

Authority: 45 I.A.C. 2.2-5-12

Taxpayer protests the imposition of sales/use tax on property consumed in production.

II. Sales & Use Tax – Manufacturing Equipment Used in Direct Production

Authority: 45 I.A.C. 2.2-5-8; 45 I.A.C. 2.2-5-10; 45 I.A.C. 2.2-5-11

Taxpayer protests the imposition of sales/use tax on items used in direct production.

III. Sales & Use Tax – Tools and Supplies Used to Repair (Remanufacture) Rollers

Authority: Rotation Products Corp. v. Department of State Revenue, 690 N.E.2d 795 (Ind. Tax 1998); 45 I.A.C. 2.2-5-8

Taxpayer protests the imposition of sales/use tax on materials used to repair rollers.

IV. Sales & Use Tax – Environmental Protection Equipment

Authority: 45 I.A.C. 2.2-5-70
04980536
PAGE 2

Taxpayer protests the imposition of sales/use tax on environmental protection equipment.

V. Sales & Use Tax – Wrapping and Labeling Materials

Authority: IC 6-2.5-5-9; 45 I.A.C. 2.2-5-16

Taxpayer protests the imposition of sales/use tax on wrapping and labeling materials.

VI. Sales & Use Tax – Services

Authority: 45 I.A.C 2.2-4-2

Taxpayer protests the imposition of sales/use tax on fire extinguisher inspection and recharge services.

VII. Sales & Use Tax – Improvement to Real Estate

Authority: 45 I.A.C 2.2-3-9

Taxpayer protests the imposition of sales/use tax on a lump-sum contract for an overhead door.

VIII. Sales & Use Tax – Credit for Overpayment in Projection Sample Period

Taxpayer protests overpayment credits not calculated in the projection.

IX. Tax Administration – Penalty

Authority: IC 6-8.1-10-2.1

Taxpayer protests the imposition of a ten percent penalty.

STATEMENT OF FACTS

Taxpayer manufactures copper alloy products. Taxpayer converts copper and brass into tube, rod and sheet products of various sizes, shapes and metal content. Taxpayer's finished products become raw materials for its customers.

Taxpayer protested several items in the sales and use tax audit. Additional relevant information will be

provided below, as necessary.

04980536

PAGE 3

I. Sales & Use Tax – Tangible Personal Property Consumed in Direct Production

DISCUSSION

During the production process, taxpayer repeatedly marks the metal to provide instruction and lot identification to production workers. Among the information and instruction marked on the product is the desired size and content of the end product. The taxpayer utilizes white paint stick crayons to mark the product. The markings are made at several stages in the process. The markings are sometimes combusted, sometimes pounded or ground out or simply evaporate. Taxpayer argues the crayons are consumed during the production process and are exempt from tax. Taxpayer is not including crayons used in general maintenance in the protest.

Pursuant to Department Regulation 45 I.A.C. 2.2-5-12, sales tax “shall not apply to sales of any tangible personal property consumed in direct production by the purchaser in the business of producing tangible personal property by manufacturing, processing, refining, or mining.” 45 I.A.C. 2.2-5-12(a). Materials are directly used in the production process if “they have an immediate effect on the article being produced. The property has an immediate effect on the article being produced if it is an essential and integral part of an integrated process which produces tangible personal property.” 45 I.A.C. 2.2-5-12(c).

Taxpayer urges the crayons are an essential and integral part of the production process and are not utilized for inventory control. The markings give necessary information to the production workers and identify the product throughout the process. The Department analogizes the crayons to an instruction sheet which would be discarded after use. The Department finds the crayons are not consumed in an exempt manner provided by the regulation and the markings have no immediate effect on the product.

FINDING

Taxpayer’s protest is denied.

II. Sales & Use Tax – Manufacturing Equipment Used in Direct Production

DISCUSSION

Taxpayer claims several items taxed in the audit should be tax exempt as they fall under the exemption for manufacturing equipment. Department Regulation 45 I.A.C. 2.2-5-8 provides an exemption for “manufacturing machinery, tools, and equipment directly used by the purchaser in direct production.”

Again, the property must have an immediate effect on the article being produced. 45 I.A.C. 2.2-5-8(c).

04980536

PAGE 4

Taxpayer has provided a list of items taxed in the audit which taxpayer believes to be tax-exempt pursuant to the above-referenced regulation.

Thermoglass cloth was used by taxpayer to insulate steam pipes on the production machines. Taxpayer argues the thermoglass cloth is an integral part of the piping on the tube mill and essential to proper operation of the equipment. Taxpayer concedes other thermoglass cloth is used for taxable purposes by maintenance workers. The thermoglass cloth used on the production machines is exempt.

A nylon safety sling is utilized to move work-in-process in the rod mill and tube mill. The sling is used to lift and move the product from one process to another. Taxpayer claims an exemption under 45 I.A.C. 2.2-5-8(f)(3) which states, "Transportation equipment used to transport work-in-process or semi-finished materials to or from storage is not subject to tax if the transportation is within the production process." The nylon safety sling is transporting work-in-process within the production process and is exempt.

Taxpayer's electrical labeling system was also found to be taxable by the auditor. Taxpayer states the electrical wiring labeling was installed with the new controls on the strip anneal system and on the tube mill.

Taxpayer argues the term "labeling" is misleading as this item is part of the electrical wiring and configuration on the tube mill. Taxpayer claims an exemption pursuant to the examples given in 45 I.A.C. 2.2-5-8(2)(b). Some types of equipment which are essential and integral to the integrated production process are exempt regardless of whether, or not, they touch the work-in-progress. Included is the electrical distribution system and related equipment used to produce or supply electricity to exempt manufacturing equipment. Pursuant to the regulation, taxpayer's electrical labeling system is exempt.

The auditor agreed to tax forklifts at only five percent (5%) because the forklifts are used almost exclusively for moving work-in-progress. Two forklift repair parts were taxed at 100%. Taxpayer argues the repair parts should be taxed at only 5%, as well. Taxpayer's protest is sustained pursuant to Department Regulation 45 I.A.C. 2.2-5-8(h) which reads:

- (1) Machinery, tools, and equipment used in the normal repair and maintenance of machinery used in the production process which are predominantly used to maintain production machinery are subject to tax.
- (2) Replacement parts, used to replace worn, broken, inoperative, or missing parts or accessories on exempt machinery and equipment are exempt from tax.

The auditor taxed at 100% all paint used on forklifts and production equipment. The taxpayer disputes this assessment and argues the paint is a repair part as opposed to a repair tool. Taxpayer again cites 45 I.A.C. 2.2-5-8(h). Taxpayer claims that when it paints a forklift or piece of manufacturing machinery, it is replacing a missing or worn part of the equipment. The paint is a component part of the equipment as it prevents

corrosion. The taxpayer distinguishes the tool (i.e.,
04980536

PAGE 5

the paintbrush) from the part or accessory (i.e., the paint). As such, taxpayer argues paint used for forklifts is 5% taxable while paint used on production equipment is exempt. Taxpayer's protest is denied. The Department finds paint is not a repair part but a maintenance item.

The auditor assessed tax on the purchase of a stretch-wrap machine. The product (i.e., metal coil) is secured to the pallet with the plastic wrap and is then ready for shipment to the customer. The product has no other container. Taxpayer cites 45 I.A.C. 2.2-5-10 which illustrates the tax-exempt sales of manufacturing machinery by using the production of whiskey as an example. In that example, the regulation states the exempt production process "ends with the final packaging of the product onto the case 45 I.A.C. 2.2-5-10(c)(2)(D). Taxpayer argues the placing of metal coils on a pallet stabilized with the plastic wrap is analogous to the whiskey production example, and the stretch-wrap machine is exempt as being part of the production process.

The auditor exempted the stretch wrap itself but not the machine under 45 I.A.C. 2.2-5-16 (Wrapping Materials and Containers). The auditor did not address 45 I.A.C. 2.2-5-10.

Taxpayer's specific use of the stretch-wrap machine does not qualify for the manufacturing equipment exemption. The production process ends at the point the processing has altered the item to its completed form, including packaging, if required. The packaging must be a necessary part of production. Taxpayer has failed to demonstrate the essential and integral nature of the stretch-wrap machine.

Taxpayer purchased photo sensor equipment (aka "electric eye") for the tube mill production process. A light beam is emitted and the sensor controls certain processes of the mill when the light beam is broken by product passing through the beam. An example of the functions performed by the light sensor is measurement of the product. When the product breaks the light beam, the sensor measures it as it passes and cuts the product at the appropriate length (as dictated by customer requirements). The light screen sensors and associated connectors are essential and integral parts of the control and operations of the tube mill machinery. The photo sensor equipment is exempt as part of the production process.

Taxpayer distinguishes between millwrights and machinists who work in the foundry. Taxpayer claims some of the foundry equipment is nearly fifty years old. Because of the age of the equipment, repairs are frequent, but there are also modifications made to make the machines compatible with newer parts. Taxpayer states the machinists complete the repairs while millwrights modify or manufacture new parts. Union rules allow millwrights to make repairs but do not allow machinists to manufacture new parts or equipment. Taxpayer claims the tools used by the millwrights are exempt if they are tools used in the manufacture of manufacturing equipment. Taxpayer cites 45 I.A.C. 2.2-5-11 which states in part:

The state gross retail tax shall not apply to sales of tangible personal property to be directly used by the purchaser in the direct production or manufacture of any

manufacturing or agricultural machinery, tools, and equipment ... 45 I.A.C. 2.2-5-11(a).

Taxpayer claims the millwrights spend approximately eighty percent (80%) of their time making new equipment. The other twenty percent (20%) is spent in repair and maintenance of manufacturing equipment. Taxpayer suggests there should be an 80% exemption on the tools used by the millwrights because of the appropriation of their time in the manufacture of manufacturing equipment. Taxpayer's protest is sustained pursuant to audit verification of millwrights appropriation of time.

FINDING

Taxpayer's protest is sustained in part and denied in part. The items which are sustained include thermoglass cloth, nylon safety sling, electrical labeling system, a percentage of forklift repair parts, photo sensor equipment, and a percentage of tools used in the manufacture of manufacturing equipment. Taxpayer's protests regarding the stretch-wrap machine and paint used on forklifts and production equipment are denied.

III. Sales & Use Tax – Tools and Supplies Used to Repair (Remanufacture) Rollers

DISCUSSION

Taxpayer also protests the imposition of tax on the purchase of tools and supplies used to repair (remanufacture) rollers. Taxpayer explains that during production hot brass is rolled to flatten and strengthen the metal. The rollers range in length and diameter. The original purchase of the rolls is exempt under 45 I.A.C. 2.2-5-8 as manufacturing machinery used in the direct production of other tangible personal property. The auditor did not dispute that exemption.

During production, the rollers are eventually pitted, scarred and become uneven. Once a roller has become damaged it must be removed from the production line and either replaced or repaired. Taxpayer states it has a separate department known as the "Roll Grinding Department" which regrinds and refinishes the rolls so they may be again used in the production process. Taxpayer claims that without the regrinding, the roller would be scrap. Taxpayer argues if it sent the rollers out to be serviced by a vendor that service would be tax exempt. Taxpayer claims there is no difference between sending the rollers to a vendor or performing the work itself.

Taxpayer argues the tools and supplies used to remanufacture the rollers are tax exempt and cites Rotation Products Corp. v. Department of State Revenue, 690 N.E.2d 795 (Ind. Tax 1998), to support its protest. Rotation involved the repair and remanufacture of roller

bearings. Some of the roller bearings were beyond repair and were discarded and new bearings were manufactured. Equipment for that process was exempt. Others needed only to be cleaned and polished. Equipment and materials used for such was subject to tax. Finally, some roller bearings required more than cleaning and polishing but were capable of being remanufactured.

Per Rotation, “there is no per se rule that repair activity cannot constitute production, the issue is the characterization of [the] repair activity as either a service or production.” Rotation at 801. “Ordinary” repair does not create new products and is properly denied the industrial exemptions. “However, ... at some point, the repair activity is so extensive in nature and so transforms the object such that it cannot be characterized as a mere [repair] service.” Id.

The Rotation court cited Department of Revenue v. Allied Drum Serv., Inc., 561 S.W.2d 323 (Ky. 1978), which defined the manufacturing process as: “Material having no commercial value for its intended purpose before processing has appreciable commercial value for its intended use after processing by machinery.” Rotation at 802. Allied Drum focused on the fact that the remanufacturing process converted a product with little or no value to a marketable product. Id.

To ensure only remanufacturing which constitutes production gets the exemption, the Rotation court laid out four factors applicable to the inquiry:

- (1) a substantially different end product (i.e., substantiality/complexity of the work done and physical changes made including addition of new parts),
- (2) article’s value before and after work done,
- (3) comparable performance with newly manufactured articles of its kind, and
- (4) whether work performed was contemplated as a normal part of life cycle of the existing article. Rotation at 802, 803.

The auditor taxed the process and stated it was this fourth factor which removed taxpayer’s work from the exemption. The auditor argued rollers were ground down and finished by the taxpayer several times in a rollers useful life. The auditor found this placed the work within the normal part of the life cycle of a roller.

Taxpayer claims an exemption under 45 I.A.C. 2.2-5-11 which provides, in part:

- (a) The state gross retail tax shall not apply to sales of tangible personal property to be directly used by the purchaser in the direct production or manufacture of any manufacturing or agricultural machinery, tools, and equipment...

The Department finds the above exemption does not apply to taxpayer’s regrinding of the
04980536

rollers. Taxpayer is not engaged in production or manufacture of manufacturing machinery. Taxpayer's regrinding process can be distinguished from Rotation. In Rotation, old elements were discarded, the grinding and polishing transformed the surface to a functional one, a computer-aided system calculated measurements and new elements were fabricated. The remanufacturing process was quite involved.

Taxpayer's process, although more involved than mere cleaning and polishing, does not rise to the substantiality and complexity of remanufacturing. The grinding and polishing does not constitute production and simply perpetuates existing products.

The auditor was correct in finding the tools were used for repair and were taxable.

FINDING

Taxpayer's protest is denied.

IV. Sales & Use Tax – Environmental Protection Equipment

DISCUSSION

The auditor assessed tax on several purchases of tangible personal property made by the taxpayer which taxpayer claims were for the purpose of complying with federal, state or local environmental requirements. Taxpayer protests the assessments and cites 45 I.A.C. 2.2-5-70. The Department regulation reads in part:

The state gross retail tax does not apply to sales of tangible personal property which constitutes, is incorporated into, or is consumed in the operation of, a device, facility, or structure predominately used and acquired for the purpose of complying with any state, local or federal environmental quality statutes, regulations or standards; and the person acquiring the property is engaged in the business of manufacturing, processing, refining, mining, or agriculture. 45 I.A.C. 2.2-5-70(a).

The auditor assessed tax on the purchase of red glyptal. Red glyptal is a liquid used in gauges to measure zinc oxide and other various particles of dust and smoke emissions created by the manufacturing process. Taxpayer argues it is required by environmental regulatory authorities to monitor and maintain certain levels of particulate in the emissions. Taxpayer has shown the red glyptal was purchased and incorporated into a device "predominantly used and acquired for the purpose of complying with" environmental quality standards. 45 I.A.C. 2.2-5-70. The purchase of red glyptal is exempt.

The auditor also assessed tax on the filters necessary to filter cutting oils and liquids from

the Roll Grinding department before they are discharged into the sludge pond. Taxpayer argues the filters are utilized pursuant to environmental protection laws. Taxpayer has provided sufficient argument to the Department to find the filters are used for exempt purposes.

Another purchase taxpayer claims was made for purposes of complying with federal or local environmental requirements was a submersible sewage pump. Taxpayer states the pump is used to move contaminated water from a pit to the process pond for treatment. Taxpayer claims contaminated water must be treated before it is discharged into the environment or sewage system. The Department does not find the purchase of the sewage pump to be required by environmental regulations.

Finally, the auditor assessed tax on semi-bulk containers. Taxpayer argues these containers are exempt and explains their necessity. Taxpayer uses the containers to collect and hold residue which must undergo further processing before disposal. The residue comes from the oil used to cool and lubricate the metal during the manufacturing process. The cleaned oil is recirculated while the residue is discharged. Taxpayer states the containers were purchased for purposes of complying with environmental regulations. Taxpayer again argues the containers are exempt under the Department regulation 45 I.A.C. 2.2-5-70. Taxpayer has not shown the containers are a component of its required environmental structure and are, therefore, not exempt.

FINDING

Taxpayer's purchases of tangible personal property (red glyptal and filters) for purposes of complying with federal, state or local environmental regulations are exempt. Other purchases (sewage pump and semi-bulk containers), not required by environmental regulations and statutes, are not exempt.

V. Sales & Use Tax – Wrapping and Labeling Materials

DISCUSSION

Taxpayer utilizes filament tape (as opposed to stretch wrap) for binding some of its products (i.e., tubing and rod) into bundles for delivery. The auditor assessed tax on this filament tape. Taxpayer cites Department regulation 45 I.A.C. 2.2-5-16, which provides an exemption for wrapping materials and containers:

- (a) The state gross retail tax shall not apply to sales of nonreturnable wrapping materials and empty containers to be used by the purchaser as enclosures or containers for selling contents to be added ...

(c) General rule. The receipt from a sale by a retail merchant of the following types of tangible personal property are exempt from state gross retail tax:

- (1) Nonreturnable containers and wrapping materials including steel strap and shipping pallets to be used by the purchaser as enclosures for selling tangible personal property.

Indiana Code section 6-2.5-5-9 also states in part:

- (d) Sales of wrapping material and empty containers are exempt from the state gross retail tax if the person acquiring the material or containers acquires them for use as nonreturnable packages for selling the contents that he adds.

Taxpayer claims the filament tape is used to “package” the straight and coiled tubing for delivery to customers. Taxpayer argues this constitutes a wrapping material which is exempt from tax. Taxpayer utilizes no other form of packaging its tube and rod products.

FINDING

Taxpayer’s protest is sustained. Taxpayer has illustrated the filament tape is utilized as a wrapping material in the sale and delivery of its products.

VI. Sales & Use Tax – Services

DISCUSSION

The provision of services is generally excluded from the retail sales tax. Department regulation 45 I.A.C. 2.2-4-2 addresses the tax treatment of services when tangible personal property is transferred in conjunction with the service. Regulation 45 I.A.C. 2.2-4-2 states in part:

Where in conjunction with rendering professional services, personal services, or other services, the serviceman also transfers tangible personal property for consideration, this will constitute a transaction of a retail merchant constituting selling at retail unless:

- (1) The serviceman is in an occupation which primarily furnishes and sells services, as distinguished from tangible personal property;
- (2) The tangible personal property purchased is used or consumed as a necessary incident to the service;
- (3) The price charged for tangible personal property is inconsequential (not to exceed 10%) compared with the service charge; and
- (4) The serviceman pays gross retail or use tax upon the tangible personal property at the time of acquisition.

The auditor assessed tax on fire extinguisher inspection and recharge services. Taxpayer has several
04980536

PAGE 11

hundred extinguishers throughout its plant and offices which are inspected regularly. Over time, the gas may escape from the extinguishers and may need to be replaced when the unit is inspected. The vendor does not charge sales tax on the inspection and recharge. The vendor separates the inspection/recharge service from the sale of parts and extinguishers. The cost of the recharge is less than 10% of the cost of the inspection. Taxpayer claims the recharge is incidental to the service and satisfies the elements of 45 I.A.C. 2.2-4-2.

FINDING

Taxpayer's protest is sustained.

VII. Sales & Use Tax – Improvement to Real Estate

DISCUSSION

The auditor assessed sales tax on an invoice for the installation of an overhead door. Taxpayer claims the contract was a lump sum agreement for improvement to realty. As such, the taxpayer claims the contractor was liable for the sales tax. Taxpayer cites 45 I.A.C. 2.2-3-9, in part:

- (e) Disposition subject to the use tax. With respect to construction materials a contractor acquired tax-free, the contractor is liable for the use tax and must remit such tax (measured on the purchase price) to the Department of Revenue when he disposes of such property in the following manner:
 - (3) Lump sum contract. He converts the construction material into realty on land he does not own pursuant to a contract that includes all elements of cost in the total contract price.

The installation of the rolling steel service door was an improvement to realty. Taxpayer has provided a copy of the invoices regarding this transaction. Taxpayer claims this was a lump sum contract and the contractor was liable for the tax.

FINDING

Taxpayer's protest is sustained pursuant to audit verification the contract included all elements of cost in the total contract price.

VIII. Sales & Use Tax – Credit for Overpayment in Projection Sample Period

DISCUSSION

04980536

PAGE 12

The auditor utilized a projection method for estimating the tax due for the audit period. Taxpayer claims sales tax was paid in error on several transactions during the sample period used for projection. The auditor recognized a credit for some overpayments. Upon closer review, taxpayer claims to have found further transactions with taxes paid erroneously. Taxpayer claims a credit, in the projection amount, should be given for these overpayments.

Taxpayer has listed the vendors and the service or tangible personal property provided by each on pages 9 through 12 of its protest brief. Taxpayer has also provided invoice documentation of these transactions in Exhibit A of its brief.

FINDING

Taxpayer's protest is sustained pursuant to audit verification.

IX. Tax Administration – Penalty

DISCUSSION

Taxpayer protests the addition of a penalty to the audit assessment. Taxpayer claims to have relied on a previous audit. However, the previous audit failed to address several items at issue in this protest and also utilized different percentages with regards to some partially exempt items. Taxpayer argues pursuant to Indiana Code section 6-8.1-10-2.1, the penalty should be waived because the taxpayer had "reasonable

FINDING

Taxpayer's protest is sustained. Taxpayer has shown reasonable cause for its failure to pay the proper amount of sales and use tax.

JB/BK/MR - 992405